

Subject: *SouthViews: Can the World Afford to Put All Hopes on Debt Contract Improvements for Sovereign Debt Workout?*

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Can the World Afford to Put All Hopes on Debt Contract Improvements for Sovereign Debt Workout?

By Yuefen Li

The lack of a formal sovereign debt restructuring mechanism has been considered by many as a serious deficit or missing link in the international financial architecture. However, even though the international debates on the topic have been going on for decades, heating up each time with the onset of a debt crisis and cooling down when the crisis was contained, up to now such debates have not yet come to fruition. With the onset of the global financial crisis and especially the legal litigation against Argentina and Greek debt crisis, the debate has become even more intensified with views more convergent than ever on the need of a mechanism. For decades, timely and orderly sovereign debt restructuring which can restore medium term debt sustainability to debtor countries as well as less costly to creditors has been the common expectation of stakeholders involved in sovereign debt restructuring, except those who want to get their windfalls in the debt crisis.

However, the introduction of a sovereign debt workout mechanism would lead to certain reform of the international financial architecture, an economically and legally complex exercise and politically challenging endeavor. The economic and legal intricacies could be worked out. There has been no lack of proposals for the design of such a mechanism.

However, the political resistance seems to be insurmountable up to now. Understandable and misconstrued fears of a mechanism are difficult to dispel. Therefore, the world is facing a situation of knowing very well what is wanted of a debt restructuring, even the elements for materializing the expectations, yet a lack of political will to go about it.

In view of the political impasse, a less painful incremental approach has been followed, i.e. improving debt contracts. This is not the first time for the world to go along this road. After the rejection of the IMF proposal for a "Sovereign Debt Restructuring Mechanism" in 2003, Collective Action Clauses ("CACs")ⁱ were introduced more widely in debt contracts with the

hope that this type of less difficult choice could miraculously solve the problems without really introducing a mechanism.

Yet so far, we are still waiting for a miracle to land on us. Recent contractual improvement proposals are more a response to the Eurozone debt crisis and the litigations against Argentine restructured bonds of 2001. The International Capital Market Association (ICMA) proposed super CACsⁱⁱ and tightened language for the *pari passu* clause. The IMF's proposals are along the same line.ⁱⁱⁱ With a few countries starting to utilize the language in their new debt contracts, there is a sense of complacency that the job is done and major weaknesses existing in the current bond contracts have been addressed.

However, these improvements would be largely pie in the sky for years and even decades. This is because the strengthened debt contract clauses can only take immediate effect with newly issued bonds. For the outstanding bonds under old debt contracts, they would nevertheless face the same weaknesses until the time when the bonds reach their respective maturity dates.

Depending on the life span of the bonds, this could be five years, ten years or even decades. The new bonds issued by sub-Saharan African countries recently since 2007 are mostly 5 to 10 years. There are many bonds with longer duration. Argentina's old bonds had a life time of 30 years. More than a decade passed since 2003 when the CACs became popularly used in debt contracts, the world is still facing the same problem for those bonds without CACs. The same will happen with the new super CACs and strengthened *pari passu*. This means before these bonds retire in the coming decades, debtor countries do not have effective protection against NML type of litigations. The incremental contractual improvements require a great deal of patience from the part of debtors during the long transitional years. Any attempts to take retroactive action and have debt swaps/exchanges to change the old weak contract clauses may not be that easy and could be considered as credit events.

This is a long wait during which one or two debt crises could take place, as debt crisis happens at almost regular intervals. The IMF press release on its proposals for contractual improvements explicitly described the concern of Directors of the IMF Board. It stated that "*it would take time for the significant stock of outstanding international sovereign bonds to mature, posing a risk to orderly restructurings, although the magnitude of such risk remains uncertain.*" The IMF subsequently estimated the outstanding amount of sovereign bonds at 900 billion dollars.

Not only a great deal of patience is needed for contractual improvements to take effect, the improved CACs also lack a blanket coverage. For instance, the revised and strengthened CACs would allow bond issuers to aggregate different series of bonds to be restructured, thus making holding out a restructuring proposal more difficult since possessing a blocking vote would require much more financial power than for a single bond. However, for some countries having limited amount of bonds either because they are new comers to the international capital market or the small size of their economies, even two-tier aggregation or stock-wide aggregation would turn out to be peanuts for large vulture funds. They can easily buy over 25% of the total bonds and can have a veto right for debt restructuring proposals. It so happens that these countries with small amount of bonds tend to be largely countries

most vulnerable towards unsustainable debt, especially for over a dozen first time Sub-Saharan sovereign bond issuers.

Contractual improvements like the CACs and new *pari passu* language are typically responding to demonstrated weaknesses of debt contracts. The problem is that debt contracts include boilerplate clauses other than *pari passu*. It is good to tighten the language of the *pari passu* clause and strip the mention of “ratable payment” which has been very much stretched in the Argentina case. However, *pari passu* is just one of the many commonly used boilerplate clauses in the debt contracts which are inevitably included in the debt contracts and in many cases neither creditors nor debtors remember their origins and purposes. People do not even bother to think about them as they have existed for centuries. The novel judicial interpretation of *pari passu* at the US court shocked the world of international finance. Who can be sure that other boilerplate clauses like confidentiality, warranties, force majeure would not be given an extended and extraordinary interpretation and supported by a judge and becomes an enforceable ruling.

However welcoming the contractual improvements are, they cannot and have not attempted to address some major systemic problems facing sovereign debt restructuring including:

- A. Procrastination or “too late and too little”** has been acknowledged as a major problem for sovereign debt restructuring, which would increase the economic cost and human suffering of sovereign debt crisis. Contractual improvements have never tempted to deal with this fundamental deficiency of debt restructuring. The stigma problem, the tendency to kick the can down the road when facing acute debt problems could not be diminished with improved CACs and *pari passu*.
- B. Legal forum fragmentation** has been a problem. Bonded debt contracts are governed mostly by US or British laws. Some are under domestic laws of the issuing sovereigns or other laws. Inconsistencies in court rulings do cause confusion and give rise to even more proliferated litigations. Legal forum fragmentation and possible lack of impartiality of certain domestic courts make orderly debt restructuring difficult.
- C. The problem of *interim financing*** cannot be redressed by contractual improvements. Yet, it is important for debtor countries to bridge the sudden dry up of external finance and smooth the debt restructuring process. It also plays an important role for giving the debtor country a fresh start and a virtuous circle of economic growth and improved ability of debt servicing.

In view of the above systemic problems which contractual improvements cannot address and deficiencies of strengthened debt contract proposals, even though contractual improvements are welcomed, they do not seem to be able to replace a sovereign debt restructuring mechanism for achieving the aspiration of timely and efficient debt restructurings. The proposals will certainly assist to attain these goals. But they are only incremental steps and far away from what we really want to achieve. This is like a doctor treating a patient. Just treating the symptom like head ache or foot ache and not the root causes may not be able to turn the patient into a healthy person. Therefore the IMF and the ICMA proposals are welcomed developments which can make CACs and *pari passu* more

potent and thus can assist over time, for some bonds for a very long time, to minimize debt restructuring problems caused by weak debt contract clauses, yet they leave some major problems for debt restructuring unanswered and untouched. To achieve orderly sovereign debt restructuring, a sovereign debt restructuring mechanism or legal framework will still be needed.

As international financial institutions have been facing mandate limitations on the topic of debt restructuring mechanism albeit research on related issues having been undertaken, the United Nations is the most important international intergovernmental institution working on the issue and keeping the topic afloat. In September 2014, the United Nations General Assembly passed a resolution entitled "Towards the establishment of a multilateral legal framework for sovereign debt restructuring processes". Subsequently, another UN GA resolution was passed to establish an UN Ad Hoc Committee to elaborate the legal framework. This is a mile stone, a historical moment for the United Nations to step in to make an important contribution to the reform of the international financial architecture, to fill in a gap in the international financial system together with all stake holders. The Ad Hoc Committee decided after its first working session in February 2015 to identify guiding principles for debt restructuring. This was meant to clarify the ultimate goals underpinning debt restructuring as well as the assumed norms regarded as the standard of correctness in behavior and practices. The principles would set out perimeters for major elements in debt restructuring processes. Some of the principles are expected to have already been enshrined in domestic legal order. Law making is more often than not a long and drawn-out process. Generally accepted principles can bridge the gap before legal framework is formally established, the moral force of the principles could be of valuable significance to encourage timely and orderly debt restructuring. The work being undertaken by the UN Ad Hoc Committee is expected to contribute to expelling fears of and de-stigmatizing an international debt restructuring mechanism, forging international consensus, formulating common guiding principles and leading to the eventual international common endeavor to work towards an international debt workout mechanism.

ⁱ A collective action clause (CAC) in debt contracts would allow agreements on debt restructuring by a supermajority of bondholders (normally 75 percent) legally binding on all the holders of that issue, including the ones who planned to hold out.

ⁱⁱ Standard Aggregated Collective Action Clauses ("CACs") for the Terms and Conditions of Sovereign Notes, August 2014, International Capital Market Association, Zurich, Switzerland.

ⁱⁱⁱ Strengthening the Contractual Framework to Address Collective Action Problems in Sovereign Debt Restructuring, Policy Paper of the International Monetary Fund, 2 September 2014, Washington, D.C.

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